EXECUTIVE SECRETARIAT
ROUTING SLIP

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		ACTION	INFO	DATE	INITIAL
1	DCI				
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9	Chm/NIC				
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11	IG				
12	Compt				
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14	D/PAO				
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Remarks

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Executive Secretary

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Date

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Executive Registry
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THE WHITE HOUSE
WASHINGTON

CABINET AFFAIRS STAFFING MEMORANDUM

Date: April 29, 1986 **Number:** 317,099 **Due By:** -----

Subject: Economic Policy Council Meeting -- April 30, 1986
1:00 P.M. Roosevelt Room

	Action	FYI
ALL CABINET MEMBERS	☐	☐
Vice President	☑	☐
State	☑	☐
Treasury	☑	☐
Defense	☐	☐
Justice	☑	☐
Interior	☑	☐
Agriculture	☑	☐
Commerce	☑	☐
Labor	☑	☐
HHS	☐	☐
HUD	☐	☐
Transportation	☑	☐
Energy	☑	☐
Education	☐	☐
Chief of Staff	☑	☐
OMB	☑	☐
CIA	☑	☐
UN	☐	☐
USTR	☑	☐
EPA	☐	☐
GSA	☐	☐
NASA	☐	☐
OPM	☐	☐
SBA	☐	☐
VA	☐	☐

	Action	FYI
CEA	☑	☐
CEQ	☐	☐
OSTP	☐	☐
Poindexter	☑	☐
Svahn	☑	☐
Chew *(For WH Staffing)*	☑	☐
Executive Secretary for:		
DPC	☐	☑
EPC	☑	☐

REMARKS:

The Economic Policy Council will meet on Wednesday, April 30, 1986 at 1:00 P.M. in the Roosevelt Room.

The agenda and background papers are attached.

RETURN TO:

☑ Alfred H. Kingon
Cabinet Secretary
456-2823
(Ground Floor, West Wing)

☐ Don Clarey
☐ Rick Davis
☐ Ed Stucky

Associate Director
Office of Cabinet Affairs
456-2800 (Room 235, OEOB)

THE WHITE HOUSE

WASHINGTON

April 29, 1986

MEMORANDUM FOR ECONOMIC POLICY COUNCIL

FROM: EUGENE J. McALLISTER EM

SUBJECT: Agenda and Papers for the April 30 Meeting

The agenda and papers for the April 30 meeting of the Economic Policy Council are attached. The meeting is scheduled for 1:00 p.m. in the Roosevelt Room.

The single agenda item will be a discussion of the domestic oil industry. The President has indicated that the Administration will review measures to preserve the viability of marginal production, so-called stripper wells, as national energy assets, as well as ensuring that Federal regulations do not discourage economically efficient production of domestic petroleum reserves. The Working Group on Domestic Oil has reviewed a number of proposed tax changes and other proposals, such as a "Buy American" provision for the Strategic Petroleum Reserve. A paper prepared by the Working Group is attached.

Attachment

THE WHITE HOUSE

WASHINGTON

ECONOMIC POLICY COUNCIL

April 30, 1986

1:00 p.m.

Roosevelt Room

AGENDA

1. Domestic Oil Industry

THE WHITE HOUSE

WASHINGTON

April 28, 1986

MEMORANDUM FOR THE ECONOMIC POLICY COUNCIL

FROM: WORKING GROUP ON DOMESTIC OIL

SUBJECT: Domestic Oil Production Incentives

In praising the benefits to American consumers resulting from recent declines in world oil prices, the President has asked that:

- The Administration review measures to preserve the viability of marginal production, so-called stripper wells, as a national energy asset, and,

- The Departments of Energy and the Interior, and other agencies ensure that Federal regulations do not discourage economically efficient production of domestic petroleum resources.

The Working Group on Domestic Oil has developed for the Council's consideration several options for administrative or legislative action to accomplish these two objectives.

BACKGROUND

The United States is unique among major oil producing countries in that a significant portion of our crude oil production comes from marginal or "stripper" wells that individually produce not more than 10, and an average of three, barrels per day. These wells are located mainly in Texas, Oklahoma, Kansas, Illinois, California and Ohio.

- Approximately 15 percent (or 1.25 million barrels per day) of U.S. oil production is provided by 460,000 domestic stripper wells.

- More than 50 percent of all stripper wells are worked by independent oil companies.

- Approximately 5 percent of all stripper wells are located on Federal lands and tribal land with a significant portion of the remainder on State-owned lands.

- Approximately 10-16 percent (or 1.25 billion barrels) of U.S. recoverable reserves are provided by stripper wells.

o While most stripper wells are economically competitive with other low-cost sources of crude oil, recent declines in world oil prices will make some of these wells uneconomic. If uneconomic production is shut in, State (and until recently Federal) regulations requiring that the wells be plugged may be triggered, leaving little likelihood that the reserve will ever be retapped in the future.

ONGOING ADMINISTRATION ACTIONS

The Administration has begun already several measures which will help achieve the President's objectives. These include the following:

- Proposing the repeal of the Windfall Profit Tax;
- Proposing comprehensive decontrol of natural gas prices, including repeal of the major provisions of the Fuel Use Act;
- Administratively waiving production requirements for marginal wells on Federal and Tribal lands;
- Resisting Superfund legislation that would impose substantially increased taxes on the domestic oil industry;
- Resisting legislation mandating a moratorium on Outer Continental Shelf drilling and similar amendments limiting Executive branch discretionary leasing authority;
- Supporting the House version of amendments to the Endangered Species Act which reforms the "incidental taking" provision of the Marine Mammal Protection Act;
- Opposing an oil import fee.

ISSUES

The Working Group has looked at several areas in which we can help maintain the viability of marginal domestic oil production. These include: tax changes; the Strategic Petroleum Reserve; Alaskan North Slope oil; and regulatory proposals.

It is difficult to gauge with any precision adequate economic incentives for retaining the capability of domestic marginal oil production at current levels as the break-even costs of production vary among each well depending upon the depth, age, production, etc. of the well.

A. Tax Proposals

There have been a number of proposals, including several by Senators Nickles and Boren, to provide relief to the domestic oil policy industry through changes in the tax code. Among these proposals are:

1. Marginal Production Tax Credit.

The proposal calls for a tax credit equal to the net operating loss incurred by a producer from marginal production. This credit, which cannot exceed $2 per barrel, may be used against either the income tax or windfall profit tax, and may be carried back 10 years and forward five years. As proposed, the net operating loss is defined as the excess (if any) of lease operating expenses, state severance and property taxes, dry hole costs, depreciation, and the allocation of overhead.

Although the proposal as stated does not define marginal production, the revenue costs noted assume marginal well production to include stripper well oil production and both heavy oil and incremental tertiary oil production, but not Alaskan oil production (see discussion below for additional assumptions).

Revenue Cost FY 1987-91: $2.3 billion ($1.8 billion if sunset at $20 per barrel, as proposed).

- o This proposal is most directly targeted at encouraging unprofitable production.

- o Dry hole costs and depreciation do not represent marginal costs of production.

- o Any rule which provides a benefit only to taxpayers showing a loss is likely to encourage tax planning and creative accounting to show losses from profitable wells, a factor not included in the revenue estimates.

- o The $2 per barrel cap is arbitrary; so also is the allowance of a dollar credit for each dollar of loss.

- o Current law already provides tax relief -- the net operating loss deduction -- to taxpayers that operate at a loss. An additional dollar-for-dollar credit can make some operators more than whole.

2. Repeal the 50% of Net Income Limitation.

The present law 50% net income limitation for percentage depletion for oil production from all properties (including non-marginal oil production) would be repealed.

Revenue Cost FY 1987-91: $0.5 billion ($0.3 billion if sunset at $20 per barrel).

- This proposal is also directly targeted at helping marginal producers.
- There is no reason to extend it to non-marginal production.
- A less costly variant, which would allow the taxpayer to pay no tax on marginal wells (but not provide an additional benefit to otherwise unprofitable production) would be to extend the limitation to 100% of net income.

3. Change the Application of Percentage Depletion.

Percentage depletion would be allowed to all owners of marginal properties.

Revenue Cost FY 1987-91: $1.9 billion ($.9 billion if sunset at $20 per barrel).

- To the extent that integrated producers do not pass on the lower crude oil prices in the form of lower prices for refined products (which to date have not fallen nearly as much as those for crude oil), they are hurt much less from lower oil prices than the independents.
- Repeal of the transfer rule (see 5 below) would accomplish much of the same results as extending percentage depletion to integrated companies.

4. Change the Rate of Percentage Depletion.

Provide a graduated rate for marginal production tied to the price for oil:

Per Barrel Price of Oil	Rate
Less than $10	30%
$10-$15	25%
$15-$20	20%
Above $20	15% (current value)

Revenue Cost FY 1987-91: $.7 billion ($.7 billion even if sunset at $20 per barrel).

- o A 15% rate is somewhat arbitrary; so also is a 30% rate.

- o The proposal would require keeping track of the market price of every barrel of oil sold (or require use of average prices which may quickly become outdated). This is currently necessary for the windfall profit tax (and has been used as an argument for its repeal).

5. Repeal the "Transfer" Rule.

Allow percentage depletion for production from acquired proven properties.

Revenue Cost FY 1987-91: $.1 billion ($.0 billion if sunset at $20 per barrel).

- o This proposal may allow wells that would be shut by integrated producers to continue to be operated by independent producers.

6. Expensing of Geological and Geophysical Costs.

Expense geological and geophysical costs. The revenue estimate noted assumes that, as in the case of intangible drilling costs, integrated producers can expense only 80% of their G&G costs; the remaining 20% must be capitalized and amortized over 36 months.

Revenue Cost FY 1987-91: $4.1 billion ($2.4 billion if sunset at $20 per barrel).

- o This proposal is not related to the issue of encouraging continued production from marginal wells.

- o This proposal may encourage greater use of more advanced technological methods of exploration (and perhaps less drilling). Treating such costs as depreciable property would achieve a similar result.

- o To the extent the taxpayer may claim percentage depletion, this proposal provides a second form of recovery of the same invested capital.

7. Repeal of the Windfall Profit Tax.

The windfall profit tax, which is scheduled to begin to phase out over 33 months starting in January 1, 1991, would be repealed.

Revenue Cost FY 1987-91: $3.9 billion ($.5 billion if sunset at $20 per barrel).

- o There is no economic justification for the windfall profit tax.
- o It does not generally burden marginal production (stripper well production by independent producers is exempt, and at expected oil prices heavy and incremental tertiary oil production would not face much, if any, WPT burden).
- o As already noted, the President favors repeal of this tax.

Detailed Revenue Estimates

The revenue costs of these proposals are shown more fully in the attached table. It should be noted that the revenue cost projections are very sensitive to oil proce assumptions. These estimates are based on the "Low Oil Price" scenario described in the Energy Information Administration's recent report on the impact of lower oil prices and energy taxes on the economy. A major feature of this scenario is that although oil prices fall to $10 per barrel in January 1986, they return to their 1985 levels by 1991.

It should also be noted that the revenue estimate presented for each proposal assumes that all of the previously listed proposals had been enacted. This interaction is particularly important in the case of the repeal of the percentage depletion net income limitation, which significantly increases the cost of the additional proposals extending the scope and rate of the percentage depletion allowance. Moreover, to the extent that percentage depletion allowance are liberalized, the cost of allowing the expensing of geological and geophysical costs increases (since these costs would otherwise be written off using cost depletion). Likewise, allowing integrated produces to claim percentage depletion greatly reduces the cost of repealing the transfer rule. Only the cost of repealing the windfall profit tax is relatively independent of the inclusion of the other proposals. It is assumed that all proposals are effective January 1, 1987, and that current tax laws otherwise apply.

B. Strategic Petroleum Reserve

Option 1: Purchase additional oil in FY 1986 for the SPR from domestic sources, by changing the existing low-bid system.

The Administration has already contracted to purchase the mandated minimum 12.8 million barrels for FY 1986. The Administration could increase the SPR in FY 1986 by an additional 7 million barrels for which we have existing storage capacity plus expand as new storage capacity becomes available.

Advantages

- o Maintains U.S. protection against a supply disruption at 90 days (an Administration commitment to IEA allies) as imports grow
- o Provides an additional market for oil, albeit small
- o Adds to U.S. reserve when prices are low

Disadvantages

- o The cost of purchase can be significant and would have to be offset elsewhere in the budget (A suggestion has been raised fo fund the new SPR fill by increasing the present customs duty on imported oil and product from a few cents to no more than $1 -- a user's fee bringing in about $1.5-2.0 billion/year.)

Option 2: Set aside some portion: e.g., up to 50 percent of future oil purchases in order to benefit domestic marginal and/or stripper producers.

This set-aside provision could be sunsetted either by time: e.g., 2-3 years, or by oil prices: e.g., $18-20/bbl.

The extent of the benefit could be obtained either by limiting the group of buyers (but use low bid within group) or through a "Buy America" type subsidy; e.g., 5-10%.

Advantages

- o Provides a direct benefit to domestic producers
- o A portion of the money spent on SPR goes to domestic companies and jobs

Disadvantages

- o This represents a Federal subsidy varying in amount by the world price; transportation and other costs, which would have to be offset elsewhere in the budget

- o This could involve practical problems with purchasing, transportation, and oil quality.

C. Alaskan North Slope Oil

Option 1: Ask Congress to lift the ban on the export on Alaskan North Slope Oil.

Option 2: Ask Congress to permit the export of up to 200,000 barrels per day annually.

Option 3: Indicate in the study on Alaskan North Slope Oil being prepared by the Commerce Department that permitting the export of Alaskan North Slope oil would be a measure that could be taken to provide relief to the domestic oil industry, without committing the Administration to seeking repeal of the export ban.

Alaska produces about 1.7 million barrels per day (b/d) of crude oil, which far exceeds demand in Alaskan or West Coast Markets. As much as 800,000 b/d are shipped to East and Gulf Coast refineries.

The Congress has enacted a series of restrictions preventing the export of oil from the U.S. The most restrictive measures apply to the Alaskan North slope oil, including a specific absolute ban in the Export Administration Act of 1985.

Advantages

- o Permitting the export of Alaska North Slope oil would increase the profits of some domestic oil producers, and revenues to the State of Alaska (through royalties, severance taxes, and State income taxes) and the Federal Government (through income taxes.)

- o The former justification for restrictions on U.S. oil exports has been overtaken by the reduced vulnerability of the U.S. to oil embargoes.

- o Exporting North Slope oil would also probably improve our bilateral trade deficit with Japan, although it is not certain how much North Slope oil the Japanese would import.

Disadvantages

- There will be strong Congressional criticism of any proposal to export North Slope oil. Forty-eight Senators and two hundred and seventy-two Representatives co-sponsored a ban on North Slope exports in the Export Administration Act.

- Lifting the ban on North Slope oil exports would not directly help the "stripper" wells.

- Removing restrictions on U.S. oil exports would seriously harm the U.S. maritime industry.

D. Possible Regulatory Relief

Modifying some of the Federal regulatory responsibilities outlined below would help the oil and gas industry, including some of the industry's marginal producers. It would do so in a manner which is economically efficient and consistent with market principles.

There are many regulations under active consideration at several Departments and Agencies. The thrust and acceptance of these regulations could be greatly advantaged by a statement of overall Administration policy and guidance. (e.g., ". . . in adopting all rules and regulations which have a direct and material impact on economically efficient exploration, development, and production of domestic petroleum resources, will fully consider every opportunity to properly strengthen our domestic petroleum capability consistent with the principles of reliance on the marketplace.")

Department of Energy

- The Federal Energy Regulatory Commission (FERC) administers wellhead price controls on natural gas producers. It also licenses and sets rates for natural gas and oil pipelines.

  - DOE could file for a rulemaking before FERC seeking a rate design for more efficient transfers for gas, which would increase production and foster transportation.

- The Economic Regulatory Administration administers restrictions on the use of natural gas by electric utilities and major industrial plants under the Fuel Use Act of 1978.

  - The ERA regulates the conditions under which gas may be imported into the U.S. and consideration could be given to changing regulations relative to rate design making domestic gas more competitive with Canadian gas.

Department of Commerce

- The Commerce Department administers restrictions on the export of crude oil and petroleum products from the United States.

Department of the Interior

- Interior encourages exploration, development, and production of oil and natural gas on Federal and Tribal lands onshore and on the OCS. The viability of the oil services industry as well as the future production is directly tied to the success of the leasing program.

- The Interior Department administers "diligence requirements" for OCS leases. Under these requirements lissees can maintain their property rights only if they begin production within five years.

- In addition Interior administers rules covering production requirements on Federal lands. Secretary Hodel this past month suspended rules that required producers to plug and abandon wells that are temporarily shut in.

Environmental Protection Agency

- EPA administers a variety of programs affecting the industry and its costs. These include EPA's underground injection control program which tests the mechanical integrity of oil and gas wells.

TABLE 1

Estimated Revenue Cost Of the Nickles-Boren Proposals (in millions of dollars).

	1987	1988	Fiscal 1989	Year 1990	1991	Total 1987-91	
Oil Price	11.44	14.06	19.12	26.91	30.42		
1. Marginal Production Tax Credit:							
Stripper well production:	250	360	244	184	164	1,203	946<1>
Heavy and tert. oil production:	244	338	226	169	144	1,123	821
						2,326	1,767
2. Repeal 50% Net Income Limitation:							
Stripper well production:	43	80	97	88	52	360	262
Heavy and tert. oil production:	2	4	5	3	2	15	12
Non-marginal oil production	11	21	28	40	50	151	73
						526	347
3. Allow Percentage Depletion for All Marginal Wells:							
Stripper well production:	47	94	149	257	333	879	361
Heavy and tert. oil production:	75	147	225	282	313	1,042	555
						1,922	915
4. Change Rate of Percentage Depletion:							
Stripper well production:	62	125	127	47	0	362	362
Heavy and tert. oil production:	52	101	100	37	0	289	289
						651	651
5. Repeal the Transfer Rule:	0	0	10	41	88	139	17
6. Expense Geological and Geophysical Costs:	447	804	895	967	1018	4,131	2,403
7. Repeal Windfall Profit Tax:	0	0	0	320	1438	2,148	534

Office of the Secretary of the Treasury
Office of Tax Analysis

April 28, 1986

<1> Totals in this column assume sunset at $20 per barrel.

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Table 2

World Oil Prices

($/barrel)

Year	OMB	CBO	Energy Information Administration
1985	26.57	27.04	
1986	24.76	24.92	
1987	23.98	23.43	11.44
1988	23.55	24.06	14.06
1989	24.17	25.09	19.12
1990	24.85	26.16	26.91
1991	25.37	27.27	30.42